

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 95-34**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Application of Tennessee sales and use taxes to the sale of tangible personal property and taxable services provided individuals under Tennessee's public health care system, known as "TennCare".

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

Effective January 1, 1994, the State of Tennessee was granted a waiver by the Secretary of Health and Human Services and the Health Care Financing Administration to withdraw from the Medicaid program and establish a public health system known as TennCare. The TennCare program replaced the existing Medicaid program with a new program of managed care. In addition, the TennCare program expanded health care coverage to include uninsured or uninsurable individuals as well as Medicaid eligible individuals. TennCare is financed by pooling current federal, state and local expenditures for indigent health care including the money that the federal government would have provided Tennessee had it remained in the Medicaid program.

Under the TennCare program, the State of Tennessee no longer directly pays for health care services delivered to Medicaid eligible individuals. Tennessee now contracts with private entities known as managed care organizations (MCOs) to provide TennCare enrollees with basic health care services. By contract, each MCO receives a set payment for each Tennessee enrollee that selects, or is assigned to, that MCO. As consideration for such payment, the MCO agrees to provide its enrollees the basic health care supplies and services it determines necessary. The MCO may either provide such supplies and services directly, or may enter into agreements with providers whereby the provider furnishes enrollees with supplies and services in exchange for payments by the MCO.

The State of Tennessee currently has contracts with twelve MCOs. Seven of these MCOs are licensed health maintenance organizations (HMOs) and five are unlicensed preferred provider organizations (PPOs). The basic distinction between a HMO and a PPO is that the HMO assumes all the risks associated with participation in the TennCare program, while the PPO assumes only limited risk and passes on most of the risk of loss to its providers.

Besides payment of the contracted flat rate amount to the MCO, TennCare is also responsible for management of the Contractor Risk Agreements and Provider Risk Agreements between it and the MCOs. This includes determination of individuals eligible for TennCare, approval of certain matters, interpretation of applicable federal and state laws, facility inspection, monitoring of contractor operations, and providing technical assistance to contractors. TennCare also handles enrollee grievance matters and provides current program information and guidelines to contractors. TennCare is responsible for payments for long term care institutional services, Medicare buy-in premiums, Medicare deductibles and Medicare coinsurance for enrollees eligible for both Medicare and TennCare.

Certain services - such as long term nursing care, mental health and mental retardation care, and certain children's services - are not handled through MCO's and their providers. When these exceptions are involved, the State of Tennessee either provides the necessary medical services and medical supplies itself through a state hospital or other state agency, or contracts with a private concern, such as a nursing home, to provide such services and supplies.

QUESTION

Are sales of medical services and medical supplies to MCOs or their providers, to provide health care to individuals under the TennCare program, subject to Tennessee sales and use taxes?

RULING

Because Tennessee law does not classify medical services as taxable services, they are not subject to sales and use taxes. Sales of medical supplies to MCOs or their providers are subject to the sales and use tax unless specifically exempted by Tennessee law.

ANALYSIS

Sales Of Medical Services Are Not Taxable And Sales Of Certain Medical Supplies Are Tax Exempt

Before addressing the question presented, it must be kept in mind that under T.C.A. §§ 67-6-102(23)(F), 67-6-212 and 67-6-342 only certain services are subject to the Tennessee sales and use tax. Although medical services are not specifically exempted

from sales and use taxes, medical services are not among those services on which the tax is imposed. Thus, regardless of the circumstances under which medical services are sold, no sales tax would apply.

In addition, the sale of many items of tangible personal property that may be sold to MCO's or their providers under the TennCare program are specifically exempted by statute from Tennessee sales and use taxes. The following exemptions are specifically set forth in the statutes:

(1) Sale of human blood, plasma or any part thereof is exempted from the tax by T.C.A. § 67-6-304 when sold by an organization exempt under 26 U.S.C.A. § 501(c)(3).

(2) The retail sale of insulin and any syringe used to dispense insulin is exempted from the tax by T.C.A. § 67-6-312.

(3) T.C.A. § 67-6-314 exempts the sale of certain medical equipment and devices, such as artificial limbs, wheelchairs, prosthetics, orthotics, special molded orthopedic shoes, walkers, crutches, surgical supports and lift devices, from the tax.

(4) Prescription eyewear, including replacement parts and industrial materials, sold to and used by a person whose business is operating a Tennessee optical laboratory where such eyewear is manufactured or fabricated, if the same person also owns or operates the facilities where the eyewear is dispensed to patients. For the exemption set forth in T.C.A. § 67-6-316(c) to apply, sales and use tax must be paid on the cost price of the eyewear dispensed to patients inside Tennessee.

(5) Sale of ostomy products or appliances for use by persons who have had colostomies, ileostomies or urostomies is exempt from the tax under T.C.A. § 67-6-317.

(6) T.C.A. § 67-6-318 exempts from the tax sales of oxygen and the equipment required to administer it when prescribed or recommended for medical treatment of humans by licensed practitioners of the healing arts.

(7) Drugs or medicines dispensed by a licensed pharmacist for humans pursuant to a prescription written by a

Tennessee licensed practitioner of the healing arts or sold to such a Tennessee licensed practitioner for use by humans are exempt under T.C.A. § 67-6-320.

(8) T.C.A. § 67-6-322 exempts from the sales and use tax any sale of tangible personal property or taxable services sold, given or donated to nonprofit homes for the aged, nonprofit blood banks, nonprofit organ banks for transplantable tissue, nonprofit hospitals, and certain other nonprofit institutions and organizations which have received a determination of exemption from the Internal Revenue Service under 26 U.S.C.A. § 501.

(9) Charges made by dentists to their patients in connection with sale or transfer of tangible personal property used in the practice of the profession of dentistry are exempt from the tax under T.C.A. § 67-6-335.

(10) Repair services to equipment used in connection with helicopters or other aircraft owned by nonprofit hospitals, government entities or other nonprofit medical facilities used for medical evacuation or transport are exempted from sales and use tax by T.C.A. § 67-6-347.

The remainder of this Revenue Ruling will address the application of sales and use taxes to the sale of medical supplies that are tangible personal property and not specifically exempted from sales and use taxes under our law.

Sales To MCO's Or Their Providers Under The TennCare Program

T.C.A. § 67-6-308 exempts sales to the U.S. Government from Tennessee sales and use tax as follows:

Notwithstanding § 67-6-501(a), no sales or use tax shall be payable on account of any direct sale or lease of tangible personal property or services to the United States, or any agency thereof created by congress, for consumption or use directly by it through its own government employees.

Departmental Rule 1320-5-1-.58, set forth below, exempts direct sales to the U.S. Government but specifically states that sales to contractors doing work for the U.S. Government are not exempt from the sales and use tax.

(1) Dealers making sales direct to the United States, or any agency thereof, shall obtain an appropriate exemption certificate, and keep it in their records as evidence of such sales.

(2) Sales made to a contractor, who may be doing contract work for the United States Government, are not exempt from the Sales and Use Tax.

T.C.A. § 67-6-329(a)(12) exempts sales to the State of Tennessee from Tennessee sales and use tax as follows:

(a) The sale at retail, the use, the consumption, the distribution and the storage for use or consumption in this state of the following tangible personal property is specifically exempted from the tax imposed by this chapter:

(12) All sales made to the state of Tennessee or any county or municipality within the state;

Departmental Rule 1320-5-1-.55, quoted below, exempts from sales and use tax all sales to the State of Tennessee or its political subdivisions provided the governmental body actually makes the purchase and obtains title to the property and directly pays the dealer for it. The Rule also states that sales to contractors for the use or benefit of the governmental body are subject to sales and use tax.

(1) Sales of tangible personal property and taxable services to the State, or a County, or Municipality within the State of Tennessee are not subject to the Sales or Use Tax provided that such governmental institution furnishes the vendor with a properly executed exemption certificate; however, any sale made to a State other than Tennessee, or a County or Municipality not located within Tennessee, is subject to the Sales Tax.

(2) In order to be a sale to the State of Tennessee, or a County or Municipality in this State, the State, County, or Municipality must make the purchase of the property or taxable service, obtain title to the property or service immediately when it is delivered, and pay directly to the dealer supplying the property or service the purchase price of such property or taxable service.

(3) Sales of tangible personal property and taxable services to a contractor or other person for the use and later benefit

of the State or a County, or Municipality in this State, are subject to the appropriate Sales and Use Tax.

Sales and use taxes are levied by T.C.A. §§ 67-6-201, 67-6-202 and 67-6-203 upon the privilege of selling at retail, using or consuming tangible personal property in Tennessee. Under T.C.A. 67-6-102(23)(F), 67-6-212 and 67-6-342, certain services are also subject to the sales tax. The incidence of the sales tax is upon the seller rather than the purchaser. Serodino, Inc. v. Woods, 568 S.W.2d 610 (Tenn. 1978) citing Central Transport Co. v. Atkins, 305 S.W.2d 940 (Tenn. 1956).

It is axiomatic that the State of Tennessee cannot levy sales and use taxes on any sale to the U.S. Government or its agencies created by Congress, for consumption or use directly by it through its own government employees. Likewise, sales to the State of Tennessee or any of its counties or municipalities are exempt from Tennessee sales and use taxes.

However, under the facts presented, no sales or use tax is being levied against either the federal government or the State of Tennessee. The sales are made, not to the U.S. Government or the State of Tennessee, but directly to MCO's or their providers. The MCO's contract with the State of Tennessee to provide, or contract with providers to provide, medical services and medical supplies to TennCare enrollees. The Tennessee sales and use tax exemptions for direct sales to the U.S. Government and the State of Tennessee found in T.C.A. §§ 67-6-308 and 67-6-329(a)(12) and Departmental Rules 1320-5-1-.58 and 1320-5-1-.55, do not apply because no direct sales to the U.S. Government or the State of Tennessee are involved.

Under the TennCare program, the providers contract with the MCO's and the MCO's contract with the State of Tennessee to provide medical services and medical supplies. But, even if the medical supplies could be said to be for the use and benefit of the state under the TennCare program, Departmental Rule 1320-5-1-.55(3) specifically states that sales of tangible personal property to a contractor for the use and later benefit of the State of Tennessee are subject to the tax.

The flat fee contract payments which TennCare makes to the MCOs remains the same regardless of whether the seller of medical supplies collects sales tax from the MCOs and pays it to the state. Thus, the State of Tennessee cannot be said to be paying the sales tax. However, even if the flat fee paid by TennCare were increased to cover the tax, application of the sales and use tax would not be prohibited.

It is true that under the TennCare program both state and federal money is used to pay the flat fee contract price to the MCOs, but this is not tantamount to a levy of sales and use taxes on the federal government or the State of Tennessee.

In Car Services, Inc. v. Tidwell, slip op. (Tenn. S.Ct. Mar. 22, 1976), an unpublished and unnumbered decision, the court held that where a federal employee rents a car in his own name and pays for it either by cash, by personal check or by credit card charge which he

later pays, Tennessee sales and use taxes are not an incident falling upon the United States or one of its instrumentality's and therefore are valid. This is true because nothing in the contract attempts to bind the U.S. Government. The fact that the government reimbursed the employee for his expenditures can not be said to obligate or bind the federal government. Id. at 2 and 3. On this issue, the court took the position that form and legal incidence are decisive and that neither substance nor economic burden can be said to be the determining factor. Id. at 3. State of Alabama v. King & Boozer et al., 62 S.Ct. 43 (1941) and Curry v. United States et al., 62 S.Ct. 48 (1941) were cited by the court in support of its position.

In United States v. New Mexico, 102 S.Ct. 1373 (1972), contractors had contracts with the federal government to manage government-owned atomic laboratories in New Mexico. The contractors procured materials and paid for the goods under an "advanced funding" procedure whereby drafts to pay for the merchandise were drawn on a special bank account containing U.S. Treasury funds. Title to the goods purchased passed directly from the vendors to the federal government.

The United States Supreme Court held that New Mexico's use tax and gross receipts tax on the sale of goods, which the court stated was in effect a sales and use tax, was not invalid as applied to purchases made by the contractors. Immunity may not be conferred simply because the tax has an effect on the United States, or even because the federal government shoulders the entire economic burden of the levy. It is constitutionally irrelevant that the United States reimbursed all the contractors' expenditures, including sales and use tax expenditures. Id. at 1382. The fact that title passed directly to the federal government from the vendor does not, of itself, make the transaction a purchase by the United States as long as the purchasing entity is sufficiently distinct from the government. Id. at 1387.

The Court concluded that tax immunity is appropriate in only one circumstance, and that is when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the government that the two cannot realistically be viewed as separate entities insofar as the activity being taxed is concerned. Id. at 1383. See also: Akron Home Medical Services, Inc. v. Lindley, 495 N.E.2d 417 (Ohio 1986) and Washington, et al., v. United States, 103 S.Ct. 1344 (1983).

CONCLUSION

Sales of medical equipment to MCO's or their providers under the TennCare program are not direct sales to the U.S. Government or to the State of Tennessee and therefore are not exempted from Tennessee sales and use taxes by Tennessee law or by the rules of this Department. In fact, Departmental Rule 1320-5-1-.55(3) specifically states that such sales are subject to the tax.

The legal principles set forth by the Tennessee Supreme Court in Car Services, Inc. v. Tidwell, Supra, are applicable here. Sales to the MCO's or their providers do not bind the State of Tennessee or the U.S. Government. Only the MCO's or the providers are obligated for the medical supplies they purchase. Thus, a sales transaction of this nature is not an incident falling upon the U.S. Government or the State of Tennessee.

Unlike the contractors in United States v. New Mexico, supra., the MCO's and their providers who contract with the State of Tennessee under TennCare are not reimbursed by the federal government or the State of Tennessee for their purchases and title to the property or services they purchase does not pass to a government entity at any time. But, like the contractors in United States v. New Mexico, supra., the MCO's and their providers operate independently from the federal government and the State of Tennessee. Therefore, under the facts presented, the case for application of Tennessee sales and use tax is even stronger than under the facts in United States v. New Mexico, supra.

Certain services, such as long term nursing care, mental health and mental retardation care, and certain children's services are not handled under TennCare or through MCO's and their providers. When these exceptions are involved, the State of Tennessee either provides the necessary medical services and medical supplies itself through a state hospital or other state agency, or contracts with a private concern, such as a nursing home, to provide such services and supplies.

In cases where the State of Tennessee contracts with providers, such as nursing homes, who provide medical supplies to TennCare enrollees, the contractors' non-exempt purchases of tangible personal property in the form of medical supplies are subject to Tennessee sales and use taxes under the same legal theories already discussed. However, in cases where the State of Tennessee directly purchases tangible personal property in the form of medical supplies and provides such medical supplies to its citizens through state hospitals or other state agencies, such purchases are not subject to sales or use taxes due to the exemption contained in T.C.A. § 67-6-329(a)(12).

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APPROVED: Ruth E. Johnson, Commissioner

DATE: 10-19-95